Much Ado About Nothing? Capital Market Reaction to Changes in Antitrust Precedent concerning Exclusive Territories

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ABSTRACT

This paper uses evidence from the capital markets to examine changes in the legal rules governing a form of non-price vertical restraint, namely, exclusive territories (ET). During the past three decades the U. S. Supreme Court has reinterpreted section 1 of the Sherman Antitrust Act concerning the treatment of ET three times, oscillating between a "rule of reason" standard and a "per se" illegality standard. To investigate the effects of these changes, we identify a sample of publicly-traded firms that are involved in ET-related antitrust litigation. When these firms win (lose) their own ET case, they experience a statistically significant stock price gain (loss). When the Supreme Court switches between standards, however, these firms' stock prices do not respond. We also identify a sample of publicly-traded franchise firms, since franchisors often employ vertical restrictions such as ET. Again, the stock prices of franchise firms do not appear to react when the Supreme Court announces changes in ET precedent. Our evidence indicates that as far as the capital markets are concerned, per se versus rule of reason treatment of ET is a distinction without a difference.

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I. Introduction

For more than three decades, economic theorists, antitrust lawyers, and policy makers have debated the competitive effects of non-price vertical restraints and the legal rules that should govern these practices.[1] Vertical restraints entail restrictions imposed on the actions of a downstream retailer or dealer by an upstream manufacturer of a product sold by the dealer.[2] Some have urged a blanket prohibition on such restraints because they may act as devices to facilitate monopoly (e.g., Comanor 1968). Others have argued that vertical restraints can promote the efficient provision of information and services to customers and that these redeeming virtues support a more moderate regulatory stance or even complete deregulation (e.g., Telser 1960, Bork 1978, and Posner 1981).[3]

The legal status of vertical restraints is governed by the Supreme Court's interpretation of the Sherman Antitrust Act's[4] Section 1 prohibition of "Every contract, combination,... or conspiracy, in restraint of trade or commerce..." This general wording provides little guidance as to what specific arrangements would constitute an antitrust violation. The Act's lack of specificity offers a significant role for the Supreme Court's interpretation of the Act to inform the lower courts and businesses about the permissibility of particular practices.

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[1]The debate continues with Anne Bingaman (1993), Assistant Attorney General for Antitrust, calling for a re-examination of the Antitrust Division's guidelines with respect to vertical restrictions.

[2]Specific non-price vertical arrangements include exclusive territories (defined in the text below), exclusive dealing (in which the manufacturer forbids a dealer from selling the products of rival manufacturers) and tying (in which the purchase of one product from a supplier is contingent upon the purchase of another from that supplier). Resale price maintenance (in which an upstream manufacturer restricts the price at which the downstream dealer can sell) is an example of a vertical restriction on price. Caves (1984) provides a detailed overview of vertical restraints.

[3]Appendix I contains the logic of the arguments and further references.

[4]26 Stat. 209 (1890).

The extensive normative debate over what the Supreme Court's approach to vertical restraints should be typically assumes that the interpretations of statutes embodied in the majority opinions of the Supreme Court set explicit precedents which act as binding constraints on lower courts so that firms know how their business practices will be treated throughout the judicial system. Business managers then are assumed to respond to these precedents by adapting their practices to the new interpretation of the Sherman Act, losing profit if the new ruling diminishes their efficiency or monopoly power and gaining profit otherwise. Only if both these conditions are met will the theoretical debates about the legal treatment of vertical restraints have practical relevance.

This paper attempts to examine these assumptions empirically. First, are the Supreme Court decisions in this area sufficiently rigid and clear that they bind lower courts? Alternatively, the Supreme Court rules regarding vertical restraints may be so imprecise that lower courts can readily distinguish a particular case from a precedent-setting case, limiting the impact of a particular precedent (e.g., Bennett 1977 and Carstensen 1989). Second, can businesses, at negligible cost, ignore or effectively circumvent limitations on particular vertical restraints? Firms may be able to substitute a variety of unrestricted practices to achieve the same results (e.g., Mathewson and Winter 1984). We investigate the empirical importance of the different legal treatments of vertical restraints by studying the capital market responses to changes in the rules governing exclusive territories.[5]

[5]Although the importance of precedent has been hotly debated among legal scholars and practitioners throughout the twentieth century (see, e.g., Simmonds 1984), the impact of precedent-setting decisions has received little systematic empirical study. An exception is Landes and Posner (1976) who examine the citation frequency of precedent-setting decisions by the lower courts.

Exclusive territories (ET) exist when a manufacturer limits the sales territory of a dealer, where the "territory" may be defined geographically or by customer class. A manufacturer, for example, may stop supplying a dealer in Chicago if that dealer wishes to move to or open a new outlet in Peoria.[6] Restrictions on customers, which the Supreme Court treats the same way as geographical ones, limit to whom a dealer can sell the manufacturer's product, e.g., people residing in one town but not another or final consumers but not wholesalers. Exclusive territories provide an excellent opportunity to investigate the empirical salience of Supreme Court vertical restrictions because the Court changed the rules governing the treatment of exclusive territories three times since the early 1960s, oscillating between moderate "rule of reason" and strict "per se illegal" positions.

In deciding antitrust cases, the Supreme Court has developed a long tradition of classifying a practice as meriting one of two standards of judicial scrutiny: per se illegality or rule of reason (e.g., Bork 1978, pp. 18-19). If a practice is deemed "per se" illegal, the plaintiff needs to prove only that the practice existed in order to prevail. No further investigation or analysis is necessary. The Court employs this method when it believes that the competitive harm of such behavior is so clear that the facts of any particular case would not ameliorate the practice's anti-competitive effects. Price fixing agreements among rival manufacturers, for example, are considered by the Court to be so obviously a restraint of trade that they are per se illegal. This harsh legal treatment is intended to send a clear signal to firms about which practices are clearly inappropriate and to encourage the bringing

[6]As part of the arrangement, the manufacturer may (but need not) promise to forbid a new dealer from entering an existing dealer's designated territory.

of lawsuits against such practices.

In contrast, the Court adopts a more lenient "rule of reason" standard when the competitive consequences of a practice are less obvious to the Court. Rule of reason treatment entails using the specific facts of the case to conduct an inquiry into both the likely anti-competitive harms and possible redeeming virtues of the practice. A court is to render judgment only after determining whether, in the environment in which the behavior occurred, the practice did indeed cause harm to competition. The burden on a plaintiff is intended to be much heavier under a rule of reason standard than under per se illegal treatment.

We investigate whether significant changes in the rules governing ET are perceived by the market to have an influence on future business profits. The Supreme Court decisions concerning ET may affect a firm's profits by changing the net returns (including expected litigation and damage award costs) from its distribution system. As we discuss in greater detail in Section II, ET was subject to rule of reason analysis following the 1963 White Motor decision, per se illegality after the 1967 Schwinn decision, and rule of reason once again following the 1977 GTE Sylvania decision. Our study examines whether the difference between "rule of reason" and "per se" treatment of antitrust practices, over which lawyers and economists have spilled much ink (e.g., Comanor 1968 and 1985 and Posner 1981), is really a distinction without a difference.[7]

In order to assess the impact of these changes, we examine the stock price behavior

[7]Stigler (1992, pp. 461-62) laments that economists have neglected analyzing the distinction between per se and rule of reason: "I would be prepared to exchange the next twenty articles on game theory in industrial organization for a major attack on the comparative efficiencies of per se and rule-of-reason policies."

of firms that use or have used ET upon the announcement of major changes in the interpretation of the law concerning ET. If Supreme Court rules governing ET matter, changes in precedent should be detected by the market and reflected in stock prices. If such precedent changes do not affect business practices and profits, however, even a significant change in the interpretation of a statute should not affect the stock market valuation of firms that use such practices. Sections III and IV discuss our data and event study method. Section V describes our results, and section VI offers our conclusions.

II. The Changing Legal Treatment of Exclusive Territories (ET)

We now consider the development of the Supreme Court's interpretation of the Sherman Act with respect to ET. Table 1 presents the votes by the Supreme Court Justices in the three cases we discuss.

White Motor[8]

Until the 1963 White Motor decision, there had been very little case law dealing with ET (see Blair and Kaserman 1985, p. 375). During the first half of this century, the lower federal courts generally permitted ET, when not part of a price fixing conspiracy. In 1948, the Antitrust Division of the Justice Department claimed that ET was per se illegal. Most firms accused of the practice negotiated consent decrees with the government, dropping ET rather than going to trial.

In the first precedent-setting case we consider, the Supreme Court refused to uphold the per se treatment of ET and adopted a rule of reason standard. The White Motor

[8] United States v. White Motor Company, 372 U.S. 253 (1963).

Company, a truck manufacturer, assigned an exclusive territory to each of its dealers. Each dealer was the sole distributor in its designated region and was permitted to sell to customers only in the assigned area. In addition, White Motor reserved a special customer class -- governments -- for itself and forbade dealers from selling to any level of government. The Justice Department challenged this distribution arrangement, and a lower court gave a summary judgment in favor of the government on the basis that the competitive harms of ET were so obvious as to not require detailed investigation.[9] White Motor appealed and the Supreme Court overturned the ruling of the lower court.

The Supreme Court felt that it had such limited experience evaluating ET that it could not abide a per se rule. In the majority opinion, Justice Douglas writes "... we know too little of the actual impact of both that [territorial] restriction and the one respecting customers to reach a conclusion on the bare bones of the documentary evidence before us."[10] The Court sent the case back to the lower court to investigate the competitive effects of ET arguing that ET restrictions "... may be allowable protections against aggressive competitors or the only practical means a small company has for breaking into or staying in business." Following White Motor, ET thus could not be condemned on its face, and a careful inquiry of costs and benefits was necessary before judgment. The Wall Street Journal (3/5/63, p.2) noted the importance of the decision for franchising and distribution arrangements involving ET that were common in many industries.

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[9]A motion for summary judgment can be granted when the judge believes that there is evidence of a per se violation so no further inquiry is needed to determine liability.

[10]372 U.S. 253 (1963) at 261.

Schwinn[11]

Four years later, the Supreme Court changed its interpretation of the Sherman Act and adopted a per se stance against ET. Schwinn, a maker of bicycles, employed a complex marketing arrangement involving exclusive territories and prohibitions of resale to discounters. Schwinn distributed bicycles to franchised dealers on a consignment basis (that is, Schwinn held title to the bicycles) and sold bicycles to wholesalers who did take title. The Justice Department sued Schwinn and asked the Supreme Court to declare such arrangements per se illegal. In its decision, the Supreme Court drew a distinction between such restrictions on merchandise in which the manufacturer retains ownership, which would continue to be subject to a rule of reason analysis as in White Motor, and restrictions on merchandise in which the dealer takes title, which now would be per se illegal: it is "unreasonable without more for a manufacturer to seek to restrict and confine areas or persons with whom an article may be traded after the manufacturer has parted with dominion over it." Schwinn thus was enjoined from placing limitations on the rights of distributors and retailers to sell products bought from Schwinn "where and to whomever they chose."[12]

As Blair and Kaserman (1985, p. 376) note, the Schwinn "ruling came as a great shock after the Court's candid admission in its White Motor decision." Justice Douglas, who had written the majority opinion in White Motor, and Justice Brennan changed their votes to now created a five-to-two majority in favor of a per se rule. On the day after the

[11]United States v. Arnold, Schwinn & Company, 388 U.S. 365 (1967).
[12]388 U.S. 365 (1967) at 378.

decision, the Wall Street Journal (6/13/67, p.32) stated that the decision "strikes down [ET] programs where the manufacturer transfers title and risk" to franchised distributors and "...will require some other manufacturers [besides Schwinn] to alter their franchise programs." The American Bar Association interpreted the decision as follows: "The Court...stated what appears to be a per se rule as to restrictions on the distributors or retailers who had actually purchased the goods for resale because they restrained the dealer's right of alienation of his property," (American Bar Association 1975, p.26).

GTE Sylvania[13]

A decade later in Continental TV v. GTE Sylvania, the Supreme Court changed the interpretation of the law with respect to ET by overruling Schwinn. GTE Sylvania, a maker of televisions, terminated one of its franchised dealers when the dealer, Continental TV, violated a location restriction in its franchise contract. Continental TV then filed suit charging a per se violation of the Sherman Act. Rather than simply distinguishing this case from Schwinn, as was argued in a lower court ruling, the Court explicitly overturned Schwinn in order to make quite clear that ET should not be per se illegal.

"[T]o the delight and astonishment of much of the business world" (Bork 1978, p. 286), the majority opinion argued that a rule of reason standard is necessary because such vertical restraints could "promote interbrand competition by allowing the manufacturer to achieve certain efficiencies in the distribution of his products."[14] The Wall Street Journal's coverage of the decision made its importance clear:

[13]Continental TV v. GTE Sylvania, 433 U.S. 36 (1977). (Justice White, in a concurring opinion, distinguished GTE Sylvania from Schwinn but resisted overturning Schwinn.)

[14]433 U.S. 36 (1977).

The ruling also means that many restrictions imposed by manufacturers -- that do not include setting the retail price -- will not violate the law if they do not unreasonably restrain competition. Some of the restrictions include limiting sales of the products to certain sites and prohibiting the sale by retailers of franchised items to non-franchised retailers.
In the decision...the court repudiated a decade-old holding by the court that such restrictions violated antitrust laws, even if they were reasonable, if title to the goods actually passed to the retailer," (WSJ, 6/24/77, p. 2).[15] –

III. Data

To investigate the impact of the precedent changes, we must identify firms most likely to be affected by changes in ET law. Unfortunately, since ET and other vertical restraints have been under a legal cloud, no source catalogues firms or products by the use of a certain type of vertical restraint. We use two methods to identify the firms. First, we construct a sample of firms involved in ET-related antitrust actions. Using the WESTLAW federal courts database, we search for cases that (a) cite one of the three precedent-setting Supreme Court decisions, (b) mention territorial (or customer) restrictions, and (c) have some antitrust content.[16] Since we are looking at capital market reactions, we include only those cases in which a litigant is listed on the University of Chicago's Center for Research on Stock Prices (CRSP) Daily Stock Returns file at the time of the case. Since the WESTLAW search may produce cases unrelated to ET,[17] we then read the court opinions and eliminate cases in which ET was not present. Finally, we check the Wall Street Journal

[15]The importance of the decision was well understood in the marketing community, for the Marketing Institute states: "the Supreme Court removed non-price vertical restraints from the per se category of antitrust violations, expressly overruling another Supreme Court decision handed down ten years before," (Favetto 1983, p. 43).

[16]Cases in WESTLAW are coded with WEST's detailed subject "keys" that permit a search for a particular topic, in addition to a search for key words and case citations.

[17]Some opinions, for example, cite and discuss our precedent-setting cases simply to establish that the case at hand is not about ET practices.

Index to insure that no major confounding events unrelated to the case (e.g., mergers) are announced around the time of the Supreme Court action. The group of 52 cases resulting from this procedure will be referred to the "defendant case sample" (see Appendix II).[18]

Second, we construct a sample of publicly traded franchise firms. In a "friend of the court" brief filed in the GTE Sylvania case, the American Franchise Association advocates overturning Schwinn because franchisors would like to use "reasonable" vertical restraints in their franchise agreements. Also, the Wall Street Journal coverage of the precedent-setting cases prominently discusses the impact on franchising.[19] To identify franchisors at different dates, we use Entrepreneur Magazine's recent "Annual Top 100 Franchises" listings and two earlier extensive surveys by the Department of Commerce, Franchise Company Data (1966) and the Franchise Opportunities Handbook (1977). We obtain the "franchise sample" by choosing all franchisor firms which are listed on the CRSP database for the relevant precedent dates. Depending upon the date, we have up to 43 firms in the franchise sample (see Appendix III).

IV. Method

The use of data from the capital markets to examine the economic effects of regulatory changes and legislative initiatives has become widespread (e.g., Binder 1985, Gilligan 1986, and Schwert 1981). Changes affecting the future discounted cash flows of

[18]This sample consists of what Weiss and White (1987) call "supersensitive" firms, that is, businesses that were themselves directly affected by the change in Supreme Court precedents in later court rulings.

[19]An article about White Motor, for instance, is titled "Franchising Fight: U.S. Mounts Antitrust Attack against Fixing of Dealers' Areas, Prices" (1/14/63, p.1), and the title of the article reporting the Schwinn decision is "Further Curbs to Franchising Set by High Court" (6/13/67, p.32).

publicly traded companies should be incorporated into the equity share price upon announcement of a rule change. The "event study" method examines the stock market behavior of firms when the new information is announced.

Our study will be conducted in two stages. First, we examine whether and how ET matters to individual firms by determining the stock price reaction of the firms in the defendant case sample on the dates of their own cases. The event date in stage one is the date on which the individual firm's case is decided.[20] We report the results for the 38 winners and for the 14 losers separately. We refer to the results of the first stage as the "own decision date" results.

We must establish the existence and sign of the reaction empirically because different economic explanations of why firms use ET provide contrasting expectations about the capital market response to the court decisions (see Appendix I for more details and references). If we find that the winners win and the losers lose in terms of stock price reaction, ET may be economically relevant to the firms for either monopoly or efficiency reasons. Some have argued ET can be used as a device to facilitate collusion among manufacturers by reducing cartel monitoring costs or to provide strategic commitments. Others have argued that ET may enhance the ability of manufacturers to ensure that dealers provide appropriate levels of sales information and post-sale services to consumers. A third argument is that ET is a device used by retailers to enforce a cartel at the retail level. On that theory, a win in an ET lawsuit could actually harm a defendant manufacturing firm.

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[20]With one exception, none of the non-precedent-setting court decisions in our sample were reported in the Wall Street Journal. For the one case which was, we use the WSJ date as the event date.

Finally, if we find no reaction, ET may be economically irrelevant to the firms involved in the lawsuits. The lack of reaction could be due to either the availability of low cost substitute instruments for ET contracts or small effects on firms' overall profitability from the loss of this particular instrument (see Mathewson and Winter 1984).[21]

Once we establish how, if at all, their own ET litigation affects the firms in our sample, we then investigate the firms' reactions to the precedent-setting decisions. Event studies are often complicated by problems of information leakage (Brown and Warner 1980 and Binder 1985). Judicial decisions, however, especially the decisions of the Supreme Court, are kept strictly under wraps until their release date.[22] In this analysis, we consider two sets of release dates. As outlined in Table 2, the event dates include the precedent-changing announcement dates and the corresponding certiorari dates.[23] Certiorari is granted when the Supreme Court agrees to hear a petition for review of a lower court ruling. The very fact that the Supreme Court chooses to hear a case may convey information to the market, possibly leading to an increase in the expected probability of a change in precedent. If the changes in precedent "matter," then both the defendant case firms and the franchise firms should react. The sign of the abnormal return for White Motor and GTE Sylvania, both of which relaxed a per se standard, should be the same for firms in both samples, and Schwinn, which introduced per se treatment, should produce the opposite reaction.[24]

[21]If precedent does matter but firms do have close substitutes for ET, however, it is difficult to explain why some firms would use ET when the practice was per se illegal during the decade after Schwinn.

[22]Weiss and White (1987), p. 569.

[23]We do not consider the White Motor certiorari date because the daily CRSP data for estimation of the market model begins only in July 1962. Each of the five events in Table 1 are reported in the Wall Street Journal the next day.

[24]Changes in the membership of the Supreme Court over time, for example, do not help to predict the outcome of ET cases (see B. White 1991).

For both stages of the analysis, we use the standard market model as the normal return-generating process, as is usual in event studies.[25]

$$R_{it} = a_i + B_i R_{mt} + e_{it}$$

where

R_{it} = common stock return of the ith firm on date t, i = 1,...,N;

R_{mt} = return on the (value-weighted) market portfolio of common stocks on date t;

a_i = estimated intercept of the market model for firm i;

B_i = estimated slope coefficient ("beta") of the market model for firm i;

e_{it} = abnormal return for the ith firm on date t.

We estimate the market model using the daily stock returns obtained from the CRSP files. The estimation period for the coefficients of the market model is 200 trading days (40 weeks) before the announcement date to 200 trading days following the announcement. The prediction errors of the market model (the "e_{it}") measure the abnormal stock returns. The abnormal returns then are calculated for specific periods surrounding the announcement, for example, a two-day abnormal return is the sum of the abnormal returns on the decision date and the next day. These cumulative abnormal returns are averaged across the firms in the sample, and this number is the cumulative average abnormal return.

[25] In their examination of how the properties of daily stock return data affect event study methods, Brown and Warner (1985) find that the market model is appropriate when the event for different firms occurs on the same calendar date, as it does here. Also, we employ the Scholes and Williams (1977) beta estimation correction technique to adjust for thinly traded securities.

V. Empirical Results

A. Own Decision Date Results

The own decision date reactions summarized in Table 3 indicate that ET is economically important to the firms involved in such cases. Winning firms experience a positive cumulative average abnormal gain of 1 1/4 percent of firm value during the week following the announcement of their successes in the ET lawsuits. The cumulative average abnormal return for the losing firms is negative 2 1/2 percent during the week after judgment is rendered in their cases. For both the winners and losers, the one-week reactions are both quantitatively large and statistically significant, especially for the losers.[26]

Rather than being economically irrelevant, ET appears to have an important impact on the expected future profitability of the firms in our sample. The signs of these results indicate that decisions which provide more lenient treatment of ET, namely White Motor and GTE Sylvania, should be like "wins" for these firms and hence associated with positive returns for the case firms. Since the more harsh treatment of ET under Schwinn is likely to raise the costs associated with firms' distribution arrangements, this precedent change should be like a "loss" and hence associated with negative returns for the case firms.[27]

B. Precedent Date Results

Defendant Case Firms and the Franchise Firms Samples

The results summarized in Table 4 indicate little, if any, reaction by the capital

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[26]Different types of cases may be brought under different legal regimes (see Priest and Klein 1984 and Glied and Kroszner 1991); however, we did not find a statistical difference in abnormal returns to firms whose cases were decided during the different eras of Supreme Court ET treatment.

[27]In terms of the various economic theories of ET discussed in Appendix I, these results are consistent with either the manufacturer's cartel or the efficiency explanations but not the dealer cartel explanation.

markets to the announcement of the precedent-changing treatments of ET. We also examine a number of lengths of event windows (from one day to one month but not reported), and the results are the same. For both the defendant case sample and the franchise sample, we do not find a statistically or economically significant cumulative average abnormal return around any of our precedent event dates, except the certiorari date for GTE Sylvania. In that case, contrary to what we would expect from the defendant case results and from the fact that the American Franchise Association supported an overturning of Schwinn, the reactions to the announcement that the Supreme Court would review the appeals court ruling in GTE Sylvania are negative for both samples.[28] While statistically significant, the average and median cumulative abnormal return are quite small.[29]

C. Robustness of the Results

To confirm the robustness of our result that ET precedent changes do not affect stock prices, we consider three alternative specifications. First, the types of lawsuits and types of litigants may change when the legal standard changes (e.g., Priest and Klein 1984). Only

[28]In the GTE Sylvania certiorari, the Supreme Court was accepting a petition from the plaintiff to rehear a federal appeals court decision in favor of the manufacturer. The negative reaction here could be interpreted as a concern by the market that the Supreme Court would overturn Sylvania's victory and extend Schwinn (since the Supreme Court overturns the lower court decision in more than half of the cases it accepts). In the Schwinn certiorari, however, the Supreme Court also was accepting a petition from the plaintiff (the government) to rehear a district court decision in favor of Schwinn.

[29]In addition to the defendant case and the franchise firm samples, we examined stock price reactions for a third group of firms which might be affected by ET precedent, namely, firms in industries in which ET has been found to be used (see Stern and Eovaldi 1984). We determined which (three and four digit SIC) industries to include based on the products involved in the actions of our defendant case sample and use COMPUSTAT classification of firms by primary SIC code to construct the samples for each industry. Eight industry groupings were formed: car and truck makers, motor vehicle parts and accessoreis, beverages, petroleum refining, photographic equipment, consumer audio and video, perfume and cosmetics, and industrial and agricultural chemicals. With a few exceptions, the stock price reactions are negligible for any industry on any precedent date. The few statistically significant reactions are not consistent either across industries for a particular announcement or within an industry across announcements. These results again support our findings for the defendant case and franchise firm samples.

manufacturers that value ET highly, for example, might use the practice when it can be challenged under a per se illegal standard. To check for these effects, we compared the mean returns for firms whose cases were decided in each of three eras: 1) before Schwinn, 2) after Schwinn but before GTE Sylvania, and 3) after GTE Sylvania. We found no statistical differences for the two-day or one-week abnormal returns in any of the three groups of firms.

Second, the costs and benefits to a firm of ET could change over time. A defendant case sample firm identified as using ET a number of years before or after a precedent event, for example, might not be affected importantly by that event. To investigate this possibility, we examine the precedent-date returns of firms whose own cases were decided "near" (within two years of) the date of a precedent switch. We again find no statistical differences when we compare the two-day and one-week precedent-event average abnormal returns for firms with cases decided within two years of a precedent switch with the abnormal returns for the rest of the firms in the sample.

Third, market participants may not respond immediately to precedent changes.[30] To assess this possibility, we extend the period during which we look for evidence of abnormal returns for our defendant case and franchise samples. Perhaps other information about the likely outcome of the case is being revealed before the decision but is not captured with the event dates we have chosen. Alternatively, market participants may not have the legal expertise to grasp the full implications of a change in antitrust law immediately, so the

[30]Given the accurate and usually prominent coverage of each of the precedent events in the Wall Street Journal, however, it does not seem plausible that market participants could be completely unaware of the potential consequences of the changes.

impact of the change may be reflected only gradually in the stock prices of affected companies. To capture these effects, we calculate the weekly cumulative average abnormal return for 12 weeks (3 months) before and 12 weeks after each of the precedent event dates.[31] Figures I and II illustrate the results around each of the five announcement dates (date 0 in each graph) for the defendant case sample and franchise sample, respectively. In each figure, the thick line represents the cumulative average abnormal return. The thin lines represent the cumulative abnormal return of the firm at the 75th, 50th (median), and 25th percentile in each sample.

For the defendant case sample, panels A. through E. of Figure I show no abnormal return activity either 12 weeks before or after any of the precedent event dates, that is, the lines in the graphs are basically flat over the six month horizon. For the franchise sample illustrated in Figure II, there appears to be more movement than in the comparable panels in Figure I. None of the cumulative average abnormal returns, however, are statistically significant over the long horizons. In addition, the upward and downward trends around the precedent switches generally are not consistent with franchisors desiring more lenient treatment for ET. The two largest movements, for example, are cumulative average abnormal losses exceeding 10 percent over the six months around the White Motor decision and the GTE Sylvania certiorari, but we would expect these precedent events to have a positive effect on the franchisors.[32]

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[31]We also examined the cumulative average abnormal returns for 40 weeks before and after each of the event dates, and the patterns (or lack thereof) are the same as for the 12 week plots reported here.

[32]We also can apply our method to an instance where a change in antitrust precedent for vertical price restrictions was expected but did not occur. At the request of the Justice Department, the Supreme Court re-examined the long-standing per se illegality of resale price maintenance (RPM) in Monsanto v. Spray-Rite [465 U.S.

VI. Conclusions

The empirical results indicate that precedent-setting antitrust decisions have little effect on the stock market valuations of firms using the vertical practice of exclusive territories. When firms involved in ET-related antitrust actions win (lose) their own ET case, they experience a statistically significant stock price gain (loss). This result suggests that ET is relevant to firm profitability and that firms do not have low cost substitutes available to avoid restrictions on the use of ET. When the Supreme Court changes from harsh ("per se" illegal) treatment of ET to more lenient ("rule of reason") treatment, and vice versa, however, these firms' stock prices do not respond.[33] For a sample of publicly-traded franchise firms, which often use vertical restrictions such as ET, we again find little evidence of a stock price reaction around the dates on which the Supreme Court announces changes in ET precedent.

These results indicate that the changes in the Supreme Court rules governing the treatment of ET have not been economically meaningful ones. Either the lower courts are

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752 (1984)]. Although the Court decided not to alter its treatment of RPM, there was an expectation that the per se rule would fall, as it had in GTE Sylvania. The WSJ (9/10/82, p. 4), for instance, reported that Assistant Attorney General for Antitrust William Baxter testified before Congress that the Supreme Court "is likely to abandon in the near future" the per se prohibition against vertical price restrictions. Previous empirical work indicates that the stock prices of individual firms faced with an RPM-related antitrust action do fall upon the WSJ announcement of the lawsuit (see Gilligan 1986 and Kroszner 1987). Using the sample of 26 firms accused of RPM in Kroszner (1987) for which stock price data is available, we consider these event dates: Monsanto's loss in the Federal Appeals Court [684 F.2d 1226] (6/28/82), the Supreme Court's granting of certiorari (3/1/83), the Supreme Court's final decision (3/21/84), and two WSJ articles about Baxter's role (9/10/82 and 9/30/83). For each of these dates, the cumulative average abnormal return is not statistically or economically significant over the two day or one week event windows.

[33]Perfect competition could mitigate but not eliminate the effects of precedent. On the own decision dates, the court decision means that a constraint on a particular firm is imposed or eliminated. There need not be any effect on its rivals. On precedent dates, in contrast, the same constraint is imposed or relaxed for all competing firms. If the affected industries are perfectly competitive, then the change in costs associated with a change in constraint will affect the size of the industry (e.g., higher costs mean higher prices so lower demand). Individual firms will be affected not relative to their rivals but by the change in the industry as a whole, so the impact of a precedent switch may be reduced.

less bound by precedent than is traditionally thought or the Supreme Court opinions have been sufficiently flexible that they provide little guidance to firms about how future courts will treat their behavior. While the Schwinn decision, for example, purported to make ET per se illegal, judges might circumvent the per se standard on rather tenuous grounds. In GTE Sylvania v. Continental TV (537 F. 2d 980), the Ninth Circuit Court of Appeals found in favor of the manufacturer by distinguishing this case from Schwinn, even though the facts on their face appear quite similar. After reviewing the Ninth Circuit's decision, the majority opinion of the Supreme Court stated: "Unlike the Court of Appeals, however, we are unable to find a principled basis for distinguishing Schwinn from the case now before us" (433 U.S. 36). Nonetheless, Justice White argued in his concurring opinion that it was possible to discriminate between the behavior in Schwinn and GTE Sylvania.

While economists and lawyers have devoted much theoretical attention to the distinction between per se and rule of reason treatment, our results indicate that this emphasis may be misplaced. As Posner (1981) argues, given the uncertainty of legal interpretation, per se versus rule of reason treatment of vertical practices may be a "distinction without a difference." The complex and heterogeneous transactions governed by antitrust law leave judges with considerable latitude to distinguish a particular case from a precedent on the facts. Firms, thus, quite reasonably might ignore legal precedent in making business decisions, changing their practices only when specifically directed to do so by a court. In such a regime, the legal system could generate large fees for lawyers and economic consultants without providing clear ex ante guidance to those responsible for making business decisions.

Our findings, along with others (e.g., Weiss and White 1987)[34], raise the possibility that in important areas of business law, precedent-setting decisions of courts have limited significance for the behavior of firms not directly involved in the litigation. The economic insignificance of particular decisions, however, need not imply that legal rules are irrelevant.[35] Although individual so-called precedent-setting opinions, even at the Supreme Court level, may not constitute "events" that affect general corporate practice, business practices may well respond to the gradual accumulation of mutually reinforcing changes in the legal environment, such as a series of Supreme Court and lower court cases, combined with changes in the practices of the Department of Justice and Federal Trade Commission. Alternatively, a more significant change in precedent -- to per se <u>legality</u>, for example -- might have a real effect. The "bright line" for legal rules, perhaps, must be much brighter than the per se versus rule of reason distinction to make a difference for the courts and economic agents.

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[34]Weiss and White (1987) study of the effect of changes in Delaware corporate law. They found that the stock prices of a sample of 50 randomly selected Delaware firms failed to react to seven important changes in Delaware's business corporations law.

[35]See, e.g., Simmonds (1984) for a discussion of the "legal realist" view that precedent is a purely formal device with little effect on individual legal decisions and, <u>pari passu</u>, on business practices.

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TABLE 1: Supreme Court voting in precedent-setting ET decisions

White Motor		Schwinn		GTE Sylvania	
Per Se Illegal	Rule of Reason	Per Se Illegal	Rule of Reason	Per Se Illegal	Rule of Reason
3	5	5	2	2	6
Clark	Douglas	*Douglas*	**Harlan**	**Brennan**	**Stewart**
Black	Brennan	*Brennan*	**Stewart**	Marshall	White*
Warren	Goldberg	**Black**			Burger
	Harlan	**Warren**			Blackmun
	Stewart	Fortas			Powell
					Stevens
White did not participate.		Clark and White did not participate.		Rehnquist did not participate. * White's concurring opinion resists overturning Schwinn.	

Note: *Italics* means Justice switched position from prior decision.
Bold means Justice's position is consistent with prior decision.

TABLE 2: Precedent event dates

Precedent Event	Date
A. White Motor Supreme Court decision	March 4, 1963
B. Schwinn certiorari granted	December 6, 1965
C. Schwinn Supreme Court decision	June 12, 1967
D. GTE Sylvania certiorari granted	October 18, 1976
E. GTE Sylvania Supreme Court decision	June 23, 1977

TABLE 3: Cumulative abnormal returns (CARs) of the defendant case firms on the announcement of the decision in their own ET-related antitrust cases

	Winning Firms' CARs		Losing Firms' CARs	
	2-Days	Week	2-Days	Week
Average	0.007	0.013	-0.012	-0.025
Median	0.005	0.013	-0.011	-0.025
T-statistic	1.212	1.889*	-2.271**	-2.244**
Percent Negative	0.421	0.395	0.714	0.786
Z-statistic[a]	0.973	1.298	-1.604	-2.138**
No. Obs.	38	38	14	14

Notes: ** denotes statistically significant at the 5 percent level (two-sided t-test).
* denotes statistically significant at the 10 percent level (two-sided t-test).

[a] The Z-statistic is defined as (N-Tp)/sqrt[Tp(1-p)], where T is the total number of parameters estimated, N is the number of negative parameter estimates, and p is the probability of a negative parameter estimate expected under the null hypothesis of no effect (p = .5).

TABLE 4: Cumulative abnormal returns (CARs) on the precedent-event dates for the defendant case sample and the franchise sample

	Defendant Case Sample CARs		Franchise Sample CARs	
	2-Day	Week	2-Day	Week
A. White Motor Decision				
Average	-0.000	-0.001	-0.003	-0.012
Median	-0.002	-0.001	-0.005	-0.015
T-statistic	-0.273	-0.244	-0.741	-1.653
Percent Negative	0.565	0.565	0.600	0.666
Z-statistic	-0.639	-0.639	-0.800	-1.333
No. Obs.	23	23	15	15
B. Schwinn Certiorari				
Average	-0.002	0.005	-0.005	0.004
Median	-0.010	0.004	-0.001	-0.006
T-statistic	-0.728	0.719	-0.929	0.313
Percent Negative	0.629	0.444	0.500	0.562
Z-statistic	-1.371	0.587	0	-0.515
No. Obs.	27	27	16	16
C. Schwinn Decision				
Average	-0.003	-0.007	0.019	0.013
Median	-0.002	-0.005	0.002	0.002
T-statistic	-0.669	-1.131	1.181	0.914
Percent Negative	0.571	0.642	0.357	0.500
Z-statistic	-0.769	-1.538	1.245	0
No. Obs.	28	28	14	14
D. GTE Sylvania Certiorari				
Average	-0.006	-0.009	-0.008	-0.012
Median	-0.005	-0.005	-0.005	-0.006
T-statistic	-1.935*	-1.760*	-1.645	-1.727*
Percent Negative	0.628	0.571	0.674	0.674
Z-statistic	-1.542	-0.857	-2.340**	-2.340**
No. Obs.	35	35	43	43
E. GTE Sylvania Decision				
Average	0.007	0.002	-0.003	-0.007
Median	0.001	-0.001	-0.003	-0.004
T-statistic	1.625	0.491	-0.681	-1.114
Percent Negative	0.400	0.542	0.561	0.561
Z-statistic	1.200	-0.507	-0.799	-0.799
No. Obs.	35	35	41	41

Note: ** denotes statistically significant at the 5 percent level (two-sided t-test).
* denotes statistically significant at the 10 percent level (two-sided t-test).

FIGURE I:
Cumulative abnormal returns by defendant case firms from 12 weeks before until 12 weeks after the ET precedent event dates. (The thick line represents the average and the thin lines represent the quartiles, i.e., 75th, median, 25th.)

A. Defendant Case Firms around White Motor Decision

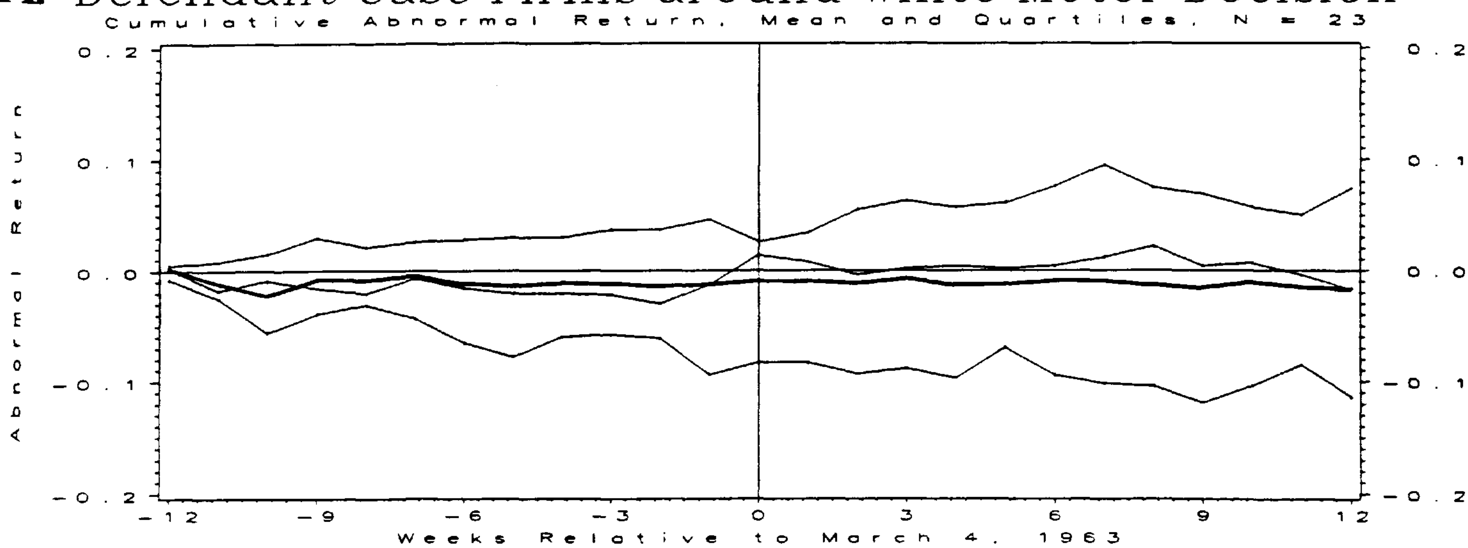
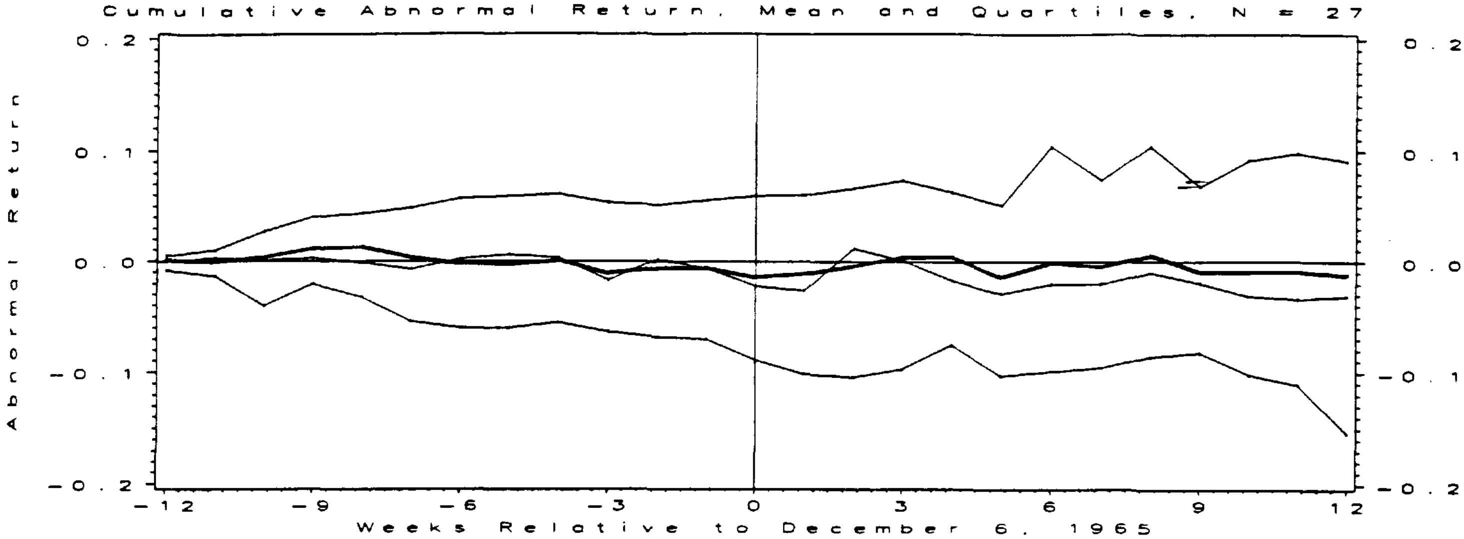


FIGURE I (continued)

B. Defendant Case Firms around Schwinn Certiorari



C. Defendant Case Firms around Schwinn Decision

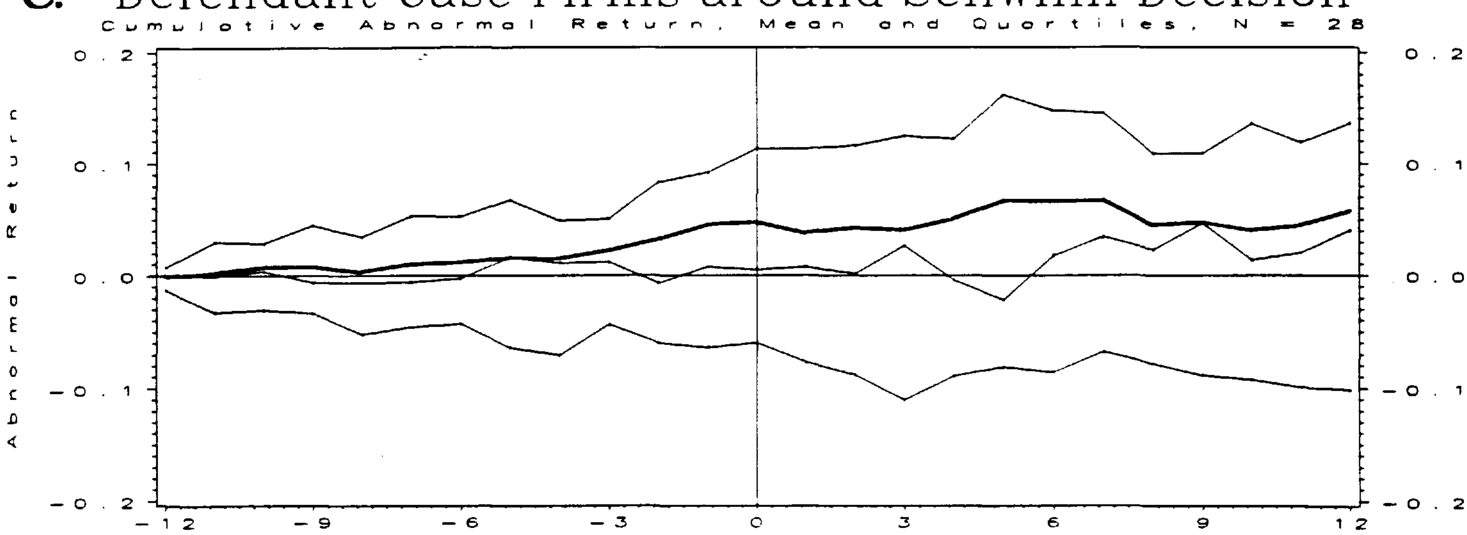
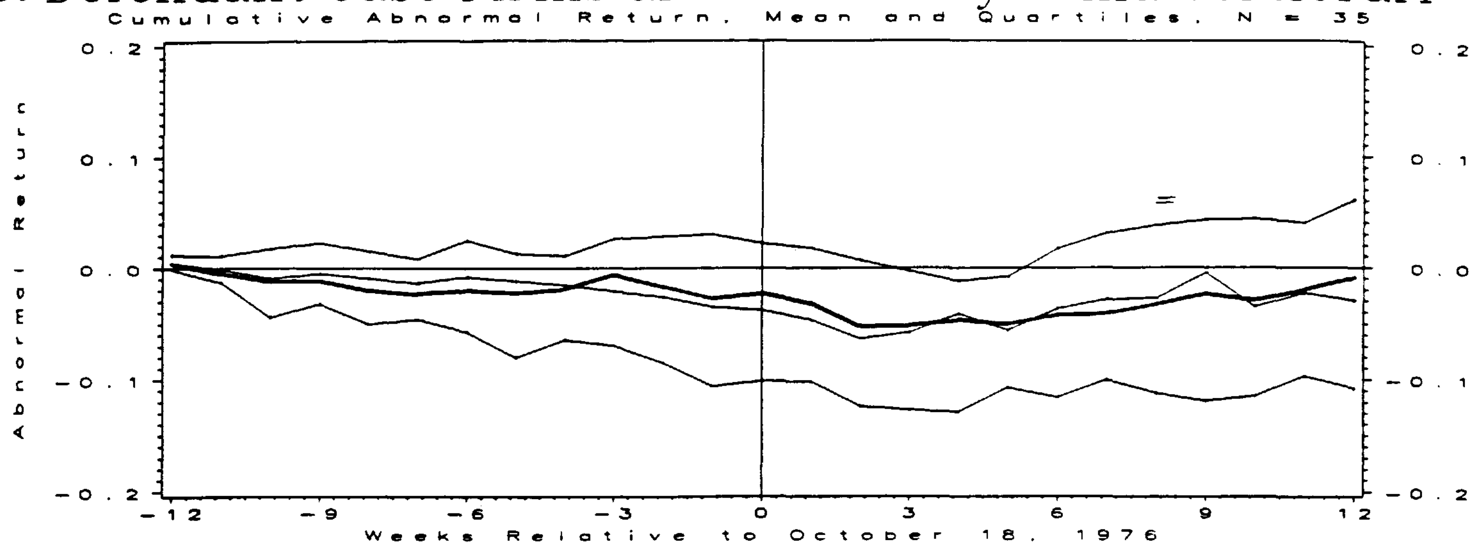


FIGURE I (continued)

D. Defendant Case Firms around GTE Sylvania Certiorari



E. Defendant Case Firms around GTE Sylvania Decision

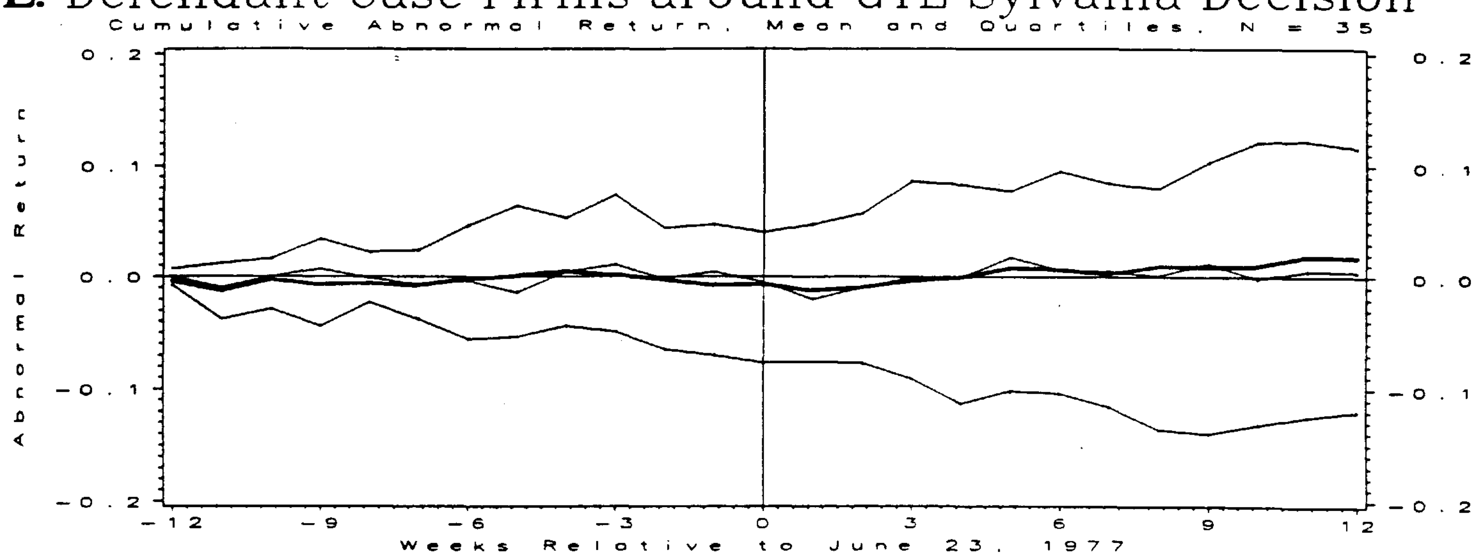


FIGURE II:

Cumulative abnormal returns by franchise firms from 12 weeks before until 12 weeks after the ET precedent event dates. (The thick line represents the average and the thin lines represent the quartiles, i.e., 75th, median, 25th.)

A. Franchise Firms around White Motor Decision

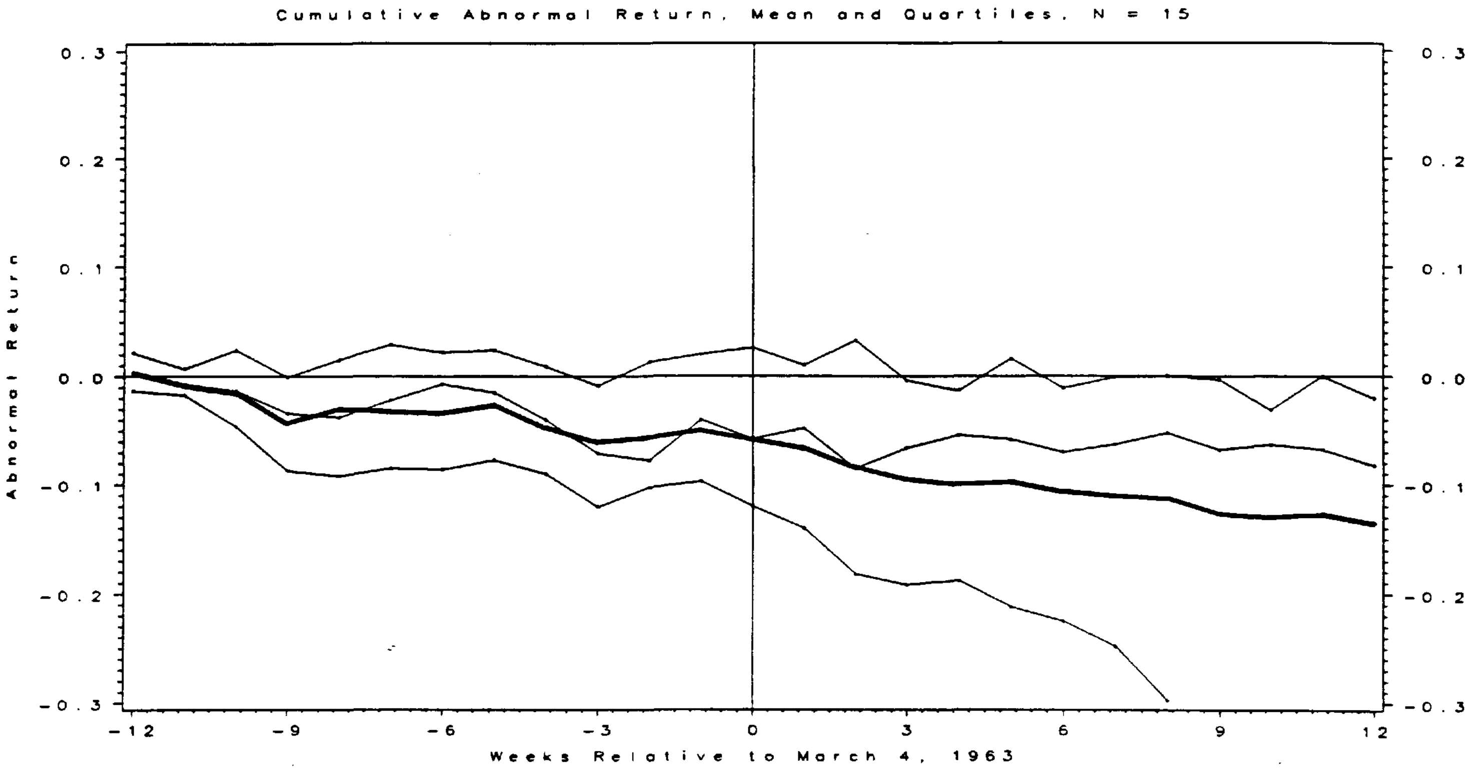
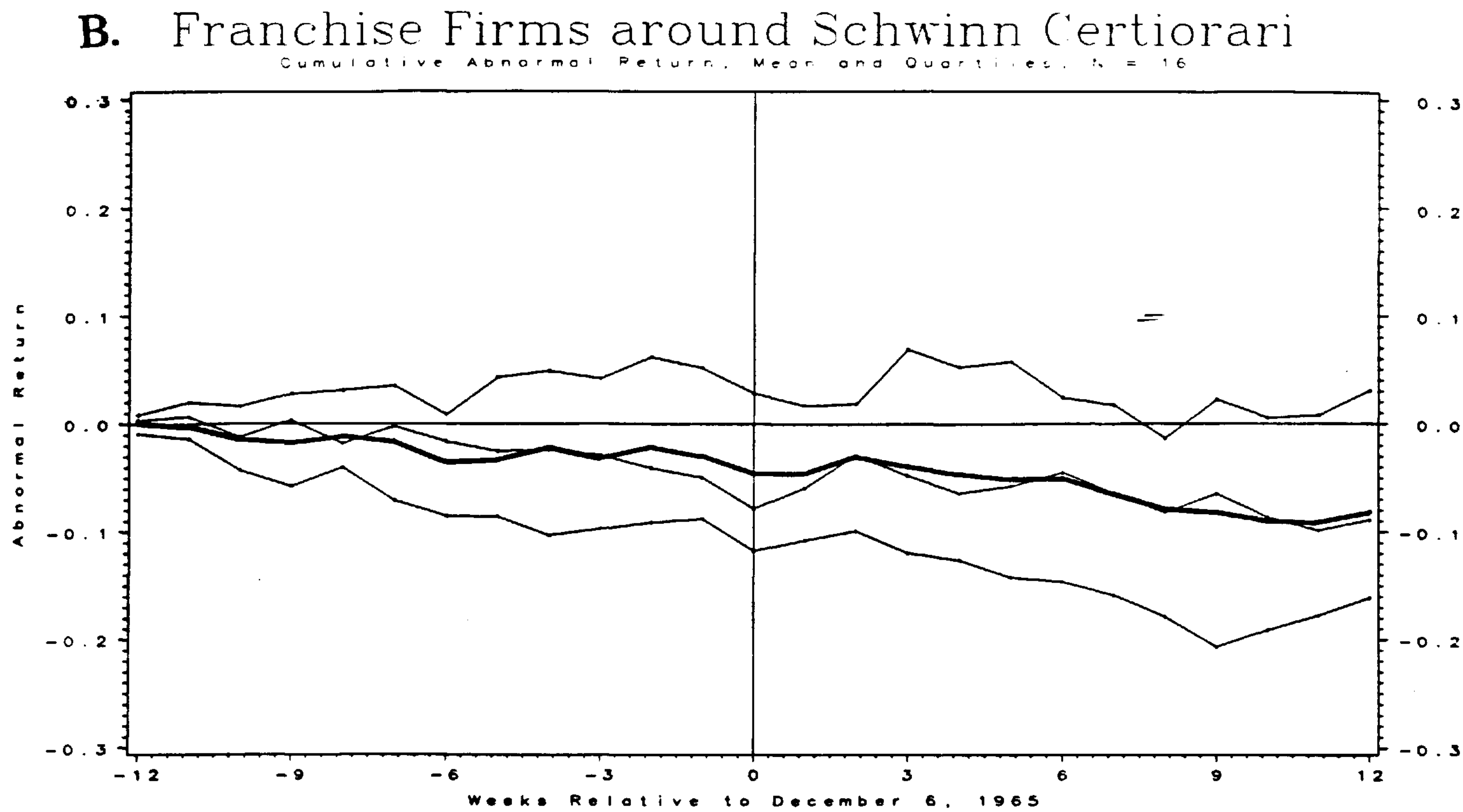


FIGURE II (continued)



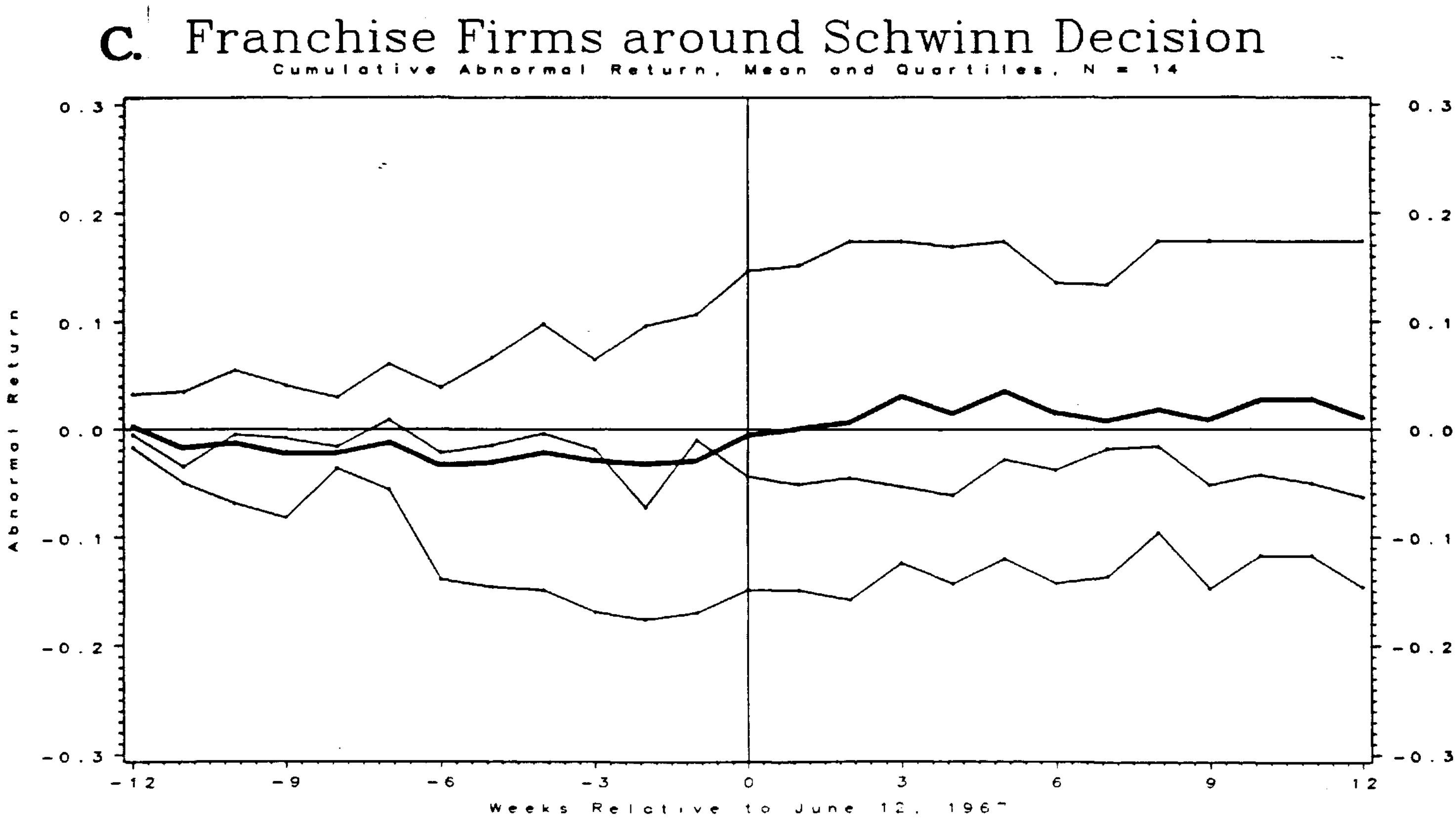
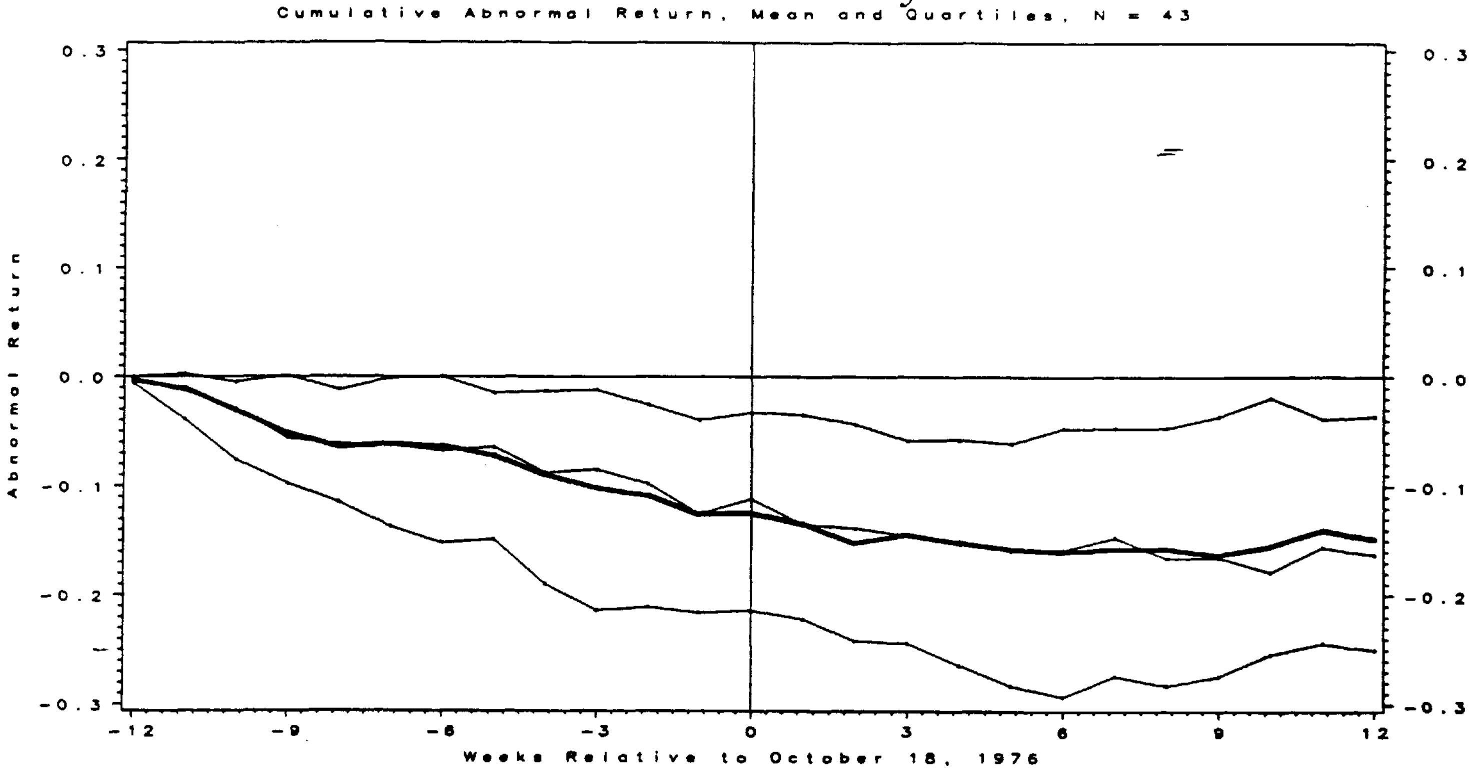
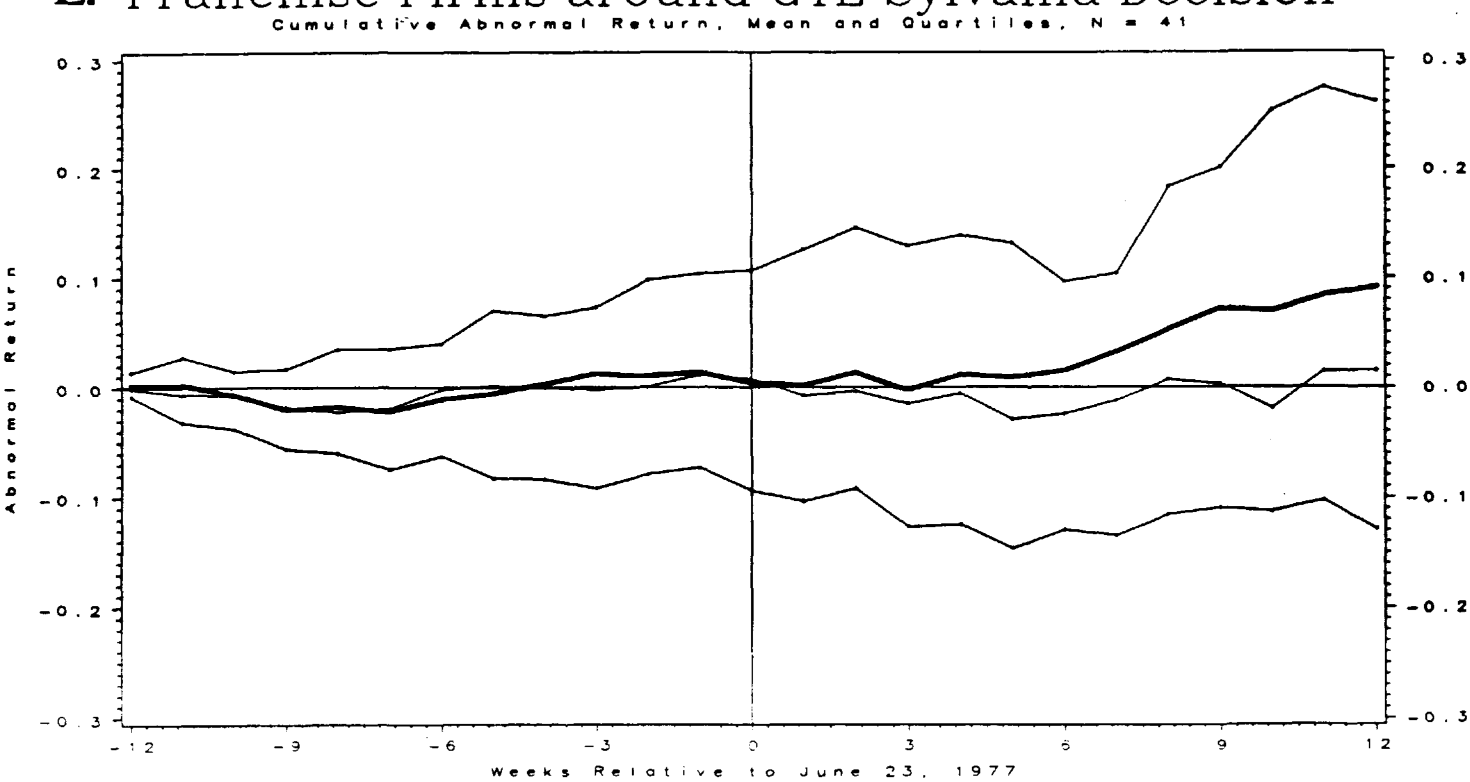


FIGURE II (continued)

D. Franchise Firms around GTE Sylvania Certiorari



E. Franchise Firms around GTE Sylvania Decision



<u>APPENDIX I:</u> Economic Theories of Exclusive Territories

Economists, lawyers, and marketing professionals have devoted much attention to the antitrust treatment of non-price vertical restraints such ET (see, e.g., Alexander and Reiffen 1993, Blair and Kaserman 1985, Bork 1978, Comanor 1968 and 1985, Hart and Tirole 1990, Mathewson and Winter 1984, Posner 1981, Rey and Stiglitz 1986, Rey and Tirole 1986, Scherer 1983, Stern 1984, and Telser 1960). We briefly outline three broad categories of explanations for exclusive territories below.

1) <u>Manufacturer Cartel</u>: Enforcement problems bedevil cartels. If monitoring is costly or imperfect, individual members of a cartel have an incentive to deviate from the cartel profit-maximizing equilibrium through "secret" distribution or price cutting (see, e.g., Stigler 1964). By reducing monitoring costs, ET may help to maintain a cartel. It is much easier to observe whether a cartel member is adhering to price and quantity agreements when the firm sells to a single purchaser in an area than when the firm is free to sell to anyone in that territory. Under this hypothesis, a firm losing (winning) an ET-related antitrust lawsuit would have a negative (positive) effect on its future discounted profit stream. The stock market reactions we find for the defendant firm sample are consistent with this prediction. A manufacturer cartel is more likely to be sustained when the industry is relatively concentrated. A four-firm concentration ratio, however, did not help to explain cross-sectional variation in the defendant firm sample abnormal returns for either the own decision date event or the precedent date events.

2) <u>Dealer Cartel</u>: ET also may be used as a facilitating practice in a dealer cartel since ET reduces or eliminates competition among dealers of a particular brand. Dealers may have difficulties enforcing a cartel by themselves, so they then enlist the help of a common agent, the manufacturer, to police the cartel through vertical restrictions such as ET. Without exclusive territories, the super-normal cartel profits would encourage dealer entry and dissipate the cartel profits. A dealer cartel is likely to exist only when the manufacturers have no option but to deal with the cartel members to market its product. Where a dual distribution system exists, in which a manufacturer sells directly to the consumer of the product as well as to a network of dealers, this explanation becomes highly unlikely. Also, this scenario is not plausible where there are a large number of dealer alternatives for similar products, that is, where there is intense interbrand competition. The results of the own decision date event for the defendant firm sample (winners gain and losers lose) are not consistent with this theory.

3) <u>Contracting and Information Costs</u>: Vertical restrictions may be imposed to align the incentives of a dealer with those of the manufacturer to achieve the most effective distribution system. ET may help to overcome free-rider problems in product-specific service provision and advertising as well as provide incentives for the efficient location of dealer outlets. Without vertical restrictions, dealers might provide insufficient pre-sale information and post-sale servicing. A potential buyer, for example, could gather information from costly demonstration set-ups and knowledgeable sales personnel at a "full service" store and then go to a "no-frills" discounter to make the purchase. Thus, high-quality dealers would not survive and customers would be underinformed. In addition, the reduction of intrabrand competition associated with ET could intensify interbrand competition. Without ET, dealers would focus on luring customers away from competing dealers instead of improving point-of-sale service. The manufacturer, as well as the representative agent in the economy, would benefit if the sales effort concentrated on selling one brand against another rather than poaching customers from other dealers. Complex items requiring more sales support and goods with a high ratio of selling-related costs to total cost of the product are thus likely candidates for the use of this practice. Finally, ET, particularly in the form of customer restrictions, may be used to facilitate market segmentation and price discrimination practices. The results of the defendant firm sample on their own decision date are consistent with this hypothesis.

APPENDIX II: Defendant Case Firms and Their Inclusion in the Precedent-Event Samples. A "1" denotes that the firm had stock price data available to be included in the corresponding precedent-event date sample (see Table 2), and "0" if not.

Company Name	Wh Mtr Dec 3/4/63	Schw Cert 12/6/65	Schw Dec 6/12/67	GTE Cert 10/18/76	GTE Dec 6/23/77
american motor inns inc	0	0	0	1	1
anheuser busch cos inc	0	0	0	0	0
ansul company(2)	1	1	1	1	1
armstrong world inds inc	1	1	1	1	1
beech aircraft corp	1	1	1	1	1
briggs & stratton corp	1	1	1	1	1
business cards intl inc	0	0	0	0	0
coca cola co(2)	1	1	1	1	1
conoco inc	1	1	1	1	1
coors adolph co(3)	0	0	0	1	1
dow chemical co	1	1	1	1	1
exxon corp	1	1	1	1	1
falstaff brewing corp(2)	1	1	1	1	1
ford motor co de	1	1	1	1	1
g t e corp(3)	1	1	1	1	1
general cinema corp	0	1	1	1	1
general motors corp	1	1	1	1	1
genrad inc	0	0	0	0	0
hobart corp	0	1	1	1	1
holiday corp	0	1	1	1	1
houston natural gas corp	0	0	0	1	1
insituform technologies inc	0	0	0	0	0
interphoto corp	0	1	1	1	1
jhirmack enterprises inc(2)	0	0	0	0	0
miller brewing cos(3)	1	1	1	1	1
mobil corp	1	1	1	1	1
monsanto company	1	1	1	1	1
north american philips corp	1	1	1	1	1
northwest industries inc	1	1	1	1	1
pepsico inc(2)	1	1	1	1	1
quaker state corp	1	1	1	1	1
ralston purina co	1	1	1	1	1
savin corp	0	0	0	1	1
shell oil co	1	1	1	1	1
sony corp	0	0	0	1	1
sperry & hutchinson co	0	0	1	1	1
studebaker worthington inc	0	0	0	1	1
uniroyal inc(2)	1	1	1	1	1
washington post co	0	0	0	1	1
white motor corp	1	1	1	1	1

Note: The number in parenthesis following the company name denotes the number of own-firm events when the firm has more than one observation in the own-date defendant case sample due to the firm's involvement in multiple ET-related actions.

APPENDIX III: Franchise Firm Samples. A "1" denotes that the firm had stock price data available to be included in the corresponding precedent-event date sample (see Table 2), and "0" if not.

Company Name	Wh Mtr Dec 3/4/63	Schw Cert 12/6/65	Schw Dec 6/12/67	GTE Cert 10/18/76	GTE Dec 6/23/77
block h & r inc	0	0	0	1	1
bonanza international inc	0	0	0	1	1
cardiff equities corp	0	0	0	1	1
carvel corp	0	0	0	1	0
churchs fried chicken inc	0	0	0	1	0
city prods corp	1	1	0	0	0
conna corp	0	0	0	1	1
country kitchen intl inc	0	0	0	1	1
culligan international co	0	0	0	1	1
dunkin donuts inc	0	0	0	1	1
f d i inc	1	1	1	1	1
fashion two twenty inc	0	0	0	1	1
firestone inc	1	1	1	1	1
frostie enterprises	0	0	0	1	1
gamble skogmo inc	1	1	1	1	1
goodrich b f co	1	1	1	1	1
goodyear tire & rubr co	1	1	1	1	1
hardees food sys inc	0	0	0	1	1
hertz corp	1	1	0	0	0
hickory farms ohio inc	0	0	0	1	1
holiday corp	0	1	1	1	1
howard johnson co	1	1	1	1	1
international dairy queen inc	0	0	0	1	1
jamco ltd	0	0	0	1	1
jerrico inc	0	0	0	1	1
jewel companies inc	1	1	1	1	1
keith clark inc	0	0	0	1	1
manpower inc new	1	1	1	1	1
marcor inc	1	1	1	0	0
mcdonalds corp	0	0	1	1	1
mcgraw edison co	1	1	1	1	1
munford inc	0	0	0	1	1
pasquale food inc	0	0	0	1	1
pizza inn inc	0	0	0	1	1
ponderosa inc	0	0	0	1	1
postal instant press	0	0	0	1	1
ramada inns inc	0	0	0	1	1
roffler industries inc	0	0	0	1	1
safeguard scientifics inc	0	0	0	1	1
servicemaster ltd partnership	0	0	0	1	1
sheraton corp amer	1	1	1	0	0
snap on tools corp	0	0	0	1	1
southland corp	0	0	0	1	1
tandy corp	1	1	1	1	1
taylor rental corp	0	0	0	1	1
travelodge intnational inc	0	0	0	1	1
wendys international inc	0	0	0	1	1
white stores inc	1	1	0	0	0

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